ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Strickland	Analyst:	Jahna Alvarado	Bill Number:	SB 462
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 26, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Qualified Manufacturers of Verified Diesel Emission Control Strategies Credit

SUMMARY

This bill would create a tax credit of $10,000 for manufacturers of verified diesel emission control strategies (VDECS).

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide a tax incentive to increase availability of VDECS and encourage manufacturers of VDECS to remain or locate in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be specifically operative for Personal Income Tax (PIT) taxpayers for taxable years beginning on or after January 1, 2009 and before December 1, 2019. Under Corporation Tax Law (CTL), this bill would be specifically operative for taxable years beginning on or after January 1, 2009, and before January 1, 2019.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation, technical, and policy concerns discussed in this analysis.

ANALYSIS

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

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FEDERAL LAW

Existing federal law does not have a credit comparable to that proposed in this bill.

STATE LAW

Prior state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6 percent of the qualified costs paid or incurred on or after January 1, 1994, and before January 1, 2004, for qualified property that was placed in service in California.

For purposes of the MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property was any of the following:

1) Tangible personal property that was defined in section 1245(a) of the Internal Revenue Code (IRC) and used in a qualified SIC Code activity, that was used primarily for:

   - manufacturing, processing, refining, fabricating, or recycling of property;
   - research and development;
   - maintenance, repair, measurement, or testing of otherwise qualified property; or
   - pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that were an integral part of specified activities.

For taxpayers engaged in computer programming and computer software-related activities, qualified property included computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

The MIC statute was repealed by its own terms and ceased to be operative as of January 1, 2004, due to the number of manufacturing sector jobs in California falling below the MIC statutory requirements.

Under current state law, CTL allows the assignment of certain credits to taxpayers that are members of a combined reporting group and adds the following provisions:

- Provides that an "eligible credit" may be assigned by a taxpayer to an "eligible assignee."
  - "Eligible credit" means any credit earned by a taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned in any taxable year beginning before July 1, 2008, which is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008.
  - "Eligible assignee" means any "affiliated corporation" that is a member of a combined reporting group at certain specified times.
  - "Affiliated corporation" means a corporation that is a member of a combined reporting group.
- Provides that the election to assign any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

Current state law limits the amount of allowable tax credits for each taxable year beginning on or after January 1, 2008, and before January 1, 2010, to an "applicable amount." "Applicable amount" is equal to 50 percent of the tax before the application of any credits. Any disallowed credit remains a credit carryover to subsequent years and the credit carryover period is increased by the number of taxable years the credit amount was disallowed. Taxpayers with business income subject to tax of less than $500,000 are excluded from this law.

<u>THIS BILL</u>

This bill would provide a non-refundable $10,000 credit for taxpayers engaged in the manufacturing of VDECS certified by the California State Air Resources Board (CARB). PIT taxpayers would be allowed the credit for taxable years beginning on or after January 1, 2009, and before December 1, 2019. Corporate taxpayers would be allowed this credit for taxable years beginning on or after January 1, 2009, and before January 1, 2019.

This bill would define "diesel particulate matter" as the particles found in the exhaust of diesel-fueled compression ignition engines.

This bill would define "manufacturing" as the activity of converting or conditioning property by changing the form, composition, quality, or character of the property for:

- retail sale, or
- use in the manufacture of a product for retail sale.

"Manufacturing" specifically includes improvements to tangible personal property resulting in a longer service life or greater functionality than that of the original property.

This bill would define "qualified taxpayer" as a manufacturer that is engaged in the manufacturing of VDECS.

This bill would define “verified diesel emission control strategies” as emissions control strategies designed primarily for the reduction of diesel particulate matter emissions that have been either certified or approved, or are pending certification and approval, by the CARB.

This bill would require that the taxpayer obtain, retain, and provide to the Franchise Tax Board upon request, the CARB certification or approval.

This bill would allow unused credits to be carried forward until exhausted.

This bill would be repealed as of December 1, 2019.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

This bill would provide a $10,000 credit for all manufacturers engaged in the manufacture of VDECS designed primarily to reduce diesel particulate matter (DPM) emissions and certified by the CARB. It is unclear how this credit would be determined. For example, would the $10,000 credit be a one-time credit, a credit allowed for each taxable year this bill would be operative, a credit allowed for each different type of VDECS, or a credit allowed for the same VDECS manufactured under multiple brands? This could lead to disputes between the department and taxpayers. The author may wish to amend this bill to clarify the allowable credit.

This bill would provide a $10,000 credit for all manufacturers engaged in the manufacture of VDECS designed primarily to reduce DPM emissions and certified by the CARB. Because a number of certified VDECS currently exist, this bill could reward existing behavior rather than providing an incentive to influence prospective taxpayer behavior. If it is the author’s intent to incentivize future behavior, then the author may wish to amend this bill to limit the credit to manufacturers of VDECS that are certified after a specific date.

This bill defines the following terms, i.e.,” diesel particulate matter,” “manufacturing,” and “ultimately sold at retail.” These definitions are unclear and could lead to disputes with taxpayers and would complicate the administration of this credit. For example, “diesel particulate matter” is defined as “the particles found in the exhaust of diesel-fueled compression ignition engines”. This definition is silent on the type of “particles”, thus all “particles” found in exhaust from the specified diesel engines would meet this bill’s definition. The author may wish to clarify the definitions in this bill to avoid disputes between the department and taxpayers.

This bill would include in the definition of “verified diesel emission control strategies” all strategies that have received or are “pending” approval or certification by the CARB. This could result in credits being claimed on VDECS that ultimately fail to receive CARB approval or certification. If it is the author’s intent to incentivize CARB approved or certified VDECS, the author may wish to amend this bill.

This bill defines “qualified taxpayer” as a “manufacturer that is engaged in the manufacturing of verified diesel emission control strategies.” This definition is unclear. Additionally, the term “engaged in” is unclear and could result in disputes between the department and taxpayers. For example, if a taxpayer that is predominantly engaged in business activities other than manufacturing has a small division engaged in manufacturing, under this bill this taxpayer would be a “qualified person” and, thus, would qualify for the credit on all purchases of tangible personal property used in a business activity totally unrelated to manufacturing. If it is the author’s intent to allow this credit for taxpayers whose principal business activity is classified as manufacturing, the author may wish to amend this bill for clarity.

This bill would provide a $10,000 annual credit for all emission control strategies that are designed primarily to reduce diesel particulate matter (DPM) emissions and certified or pending certification by the CARB. If it is the author’s intent to allow this credit for certain categories, types, or levels of DPM reduction, the author may wish to amend this bill to define eligible VDECS to avoid taxpayer confusion and increase the ease of administration.

Existing law provides tax credits for sales and use taxes paid on manufacturing equipment purchased for use in enterprise zones and program areas. In addition, a tax credit is available for recycling equipment. Nothing in this credit provision prevents a taxpayer from claiming certain multiple credits (i.e., enterprise zone, recycling, and the credit that this bill would allow) for the same VDECS manufacturing activity.

This bill is silent on if this credit would reduce tentative minimum tax (TMT)[1]. If it is the author’s intent for this credit to reduce TMT, amendments are necessary.

This bill is silent regarding the assignment of this business tax credit. Beginning on or after January 1, 2009, a taxpayer that is a member of a combined reporting group can assign business tax credits to taxpayers within that group. Assigned credits can only be applied to reduce a tax liability in taxable years beginning on or after January 1, 2010. Consequently, under existing law, any assigned business tax credit would not be claimed until taxable years beginning on or after January 1, 2010. In the absence of language to the contrary, this credit could be assigned to other members of a combined reporting group.

In addition, because this bill provides for a tax credit for the same period for which credits are limited to 50 percent of the tax liability for specified taxpayers, this credit would be subject to the 50 percent limit under current law. If this is not the author’s intent, it is recommended that this bill be amended to exclude this credit from the 50 percent limitation.

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1 In the computation of the alternative minimum tax (AMT), various adjustments are made to regular taxable income to arrive at alternative minimum taxable income (AMTI). The minimum tax rate, which can be lower than the regular tax rate, is applied to AMTI to derive the tentative minimum tax (TMT). If the TMT exceeds the regular income tax for that year, the excess is the taxpayer’s AMT for that year. On the other hand, if regular tax exceeds TMT, there is no AMT for that year.

TECHNICAL CONSIDERATIONS

This bill would allow a credit under the PITL for taxable years beginning on or after January 1, 2009, and before December 1, 2019. However, the credit would be allowed for taxable years beginning on or after January 1, 2009, and before January 1, 2019 under the CTL provision. If it is the author's intent for the credit to apply to the same taxable years for both PIT and corporate taxpayers, Amendment 1 is provided to correct this inconsistency.

LEGISLATIVE HISTORY

SB 464 (Strickland, 2009/2010) would allow a tax credit of 5 percent of the cost, limited to a maximum credit of $10,000, to obtain tangible personal property used to meet diesel particulate matter reduction requirements under specified CARB regulations. SB 464 is currently in the Senate Revenue and Taxation Committee.

AB 1452 (Committee on Budget, Stats. 2008, Ch. 763) limited the allowable business credit for PIT and CTL taxpayers with business income greater than or equal to $500,000 to 50 percent of the total available credit for taxable years beginning in 2008 and 2009. The carryover period for any credit amount in excess of the limitation is extended by the same period as the period the credit was suspended. AB 1452 also allowed a one time, irrevocable assignment of credits by CTL taxpayers to another taxpayer that is a member of a combined reporting group. Assignments can be made in taxable years beginning on or after July 1, 2008. Assigned credits cannot reduce tax for any taxable year beginning before January 1, 2010.

AB 1998 (Dutton, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005, and extended the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 failed passage in the Assembly Revenue and Taxation Committee.

AB 2070 (Houston, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 failed passage in the Assembly Revenue and Taxation Committee.

SB 1295 (Morrow, 2003/2004) would have reinstated the previous MIC for taxable years beginning on or after January 1, 2004, and increased the rate of credit from 6 percent to 8 percent. SB 1295 failed passage in the Senate Revenue and Taxation Committee.

SB 676 (Alquist, Ch. 751, Stats. 1994) made clarifying changes to the MIC, and added provisions allowing the credit for leased property, but only to the lessee.

SB 671 (Alquist, Ch. 881, Stats. 1993) enacted the MIC.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The survey was limited to income or franchise tax benefits related to manufacturers of diesel emission control equipment.

No comparable tax credit was located for any of the states included in the review.

FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses.

Estimated Revenue Impact of SB 462 As Introduced 02/26/09 Effective for tax years BOA 01/01/09		
2009/10	2010/11	2011/12
-$300,000	-$400,000	-$500,000

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The number of manufacturers of VDECS certified by the CARB and the amount of credits applied to reduce tax liabilities would determine the revenue impact of this bill.

Currently the CARB has certified 40 VDECS. This estimate assumes that under this bill, each VDECS would generate a $10,000 credit against net tax for its manufacturer for each taxable year from 2009 through 2019.

Due to the changes in the corporation tax (limitation on use of credits in tax year 2009, assignment of credits starting in taxable year 2010, and the single sales factor election starting in taxable year 2011) the usage of credits generated under this bill would fluctuate for taxable years 2009 through 2011.

For 2009, the $400,000 annual credit (40 VDECS X $10,000) generated would be used at a rate of 40 percent or $160,000 in 2009 ($400,000 X 40%), 20 percent or $80,000 in 2010 ($400,000 X 20%), and 40 percent or $160,000 ($400,000 X 40%) in 2011. Annual credits generated of $400,000 in 2010 through 2019 are anticipated to be utilized at a rate of 50 percent or $200,000 the first year ($400,000 X 50%), 40 percent or $160,000 the second year ($400,000 X 40%), and 10 percent or $40,000 ($400,000 x 10%) the third year.

Taxable year estimates are converted to fiscal year cash flow estimates in the table. For example, the fiscal year 2009/10 impact of -$300,000 is a result of the 2009 credit utilization of $160,000 and reduced estimated payments for the subsequent year.

ARGUMENTS/POLICY CONCERNS

If this bill is intended to provide an incentive for future VDECS, the inclusion of either a binding contract date or a prospective operative date may be appropriate to more fully act as an inducement for future action or behavior, rather than providing a benefit for action taken without regard to this credit.

This bill would allow a credit to all manufacturers of VDECS without restriction. If this bill is intended to provide an incentive to increase investment in the manufacture of certified VDECS within California, the author may wish to amend this bill.

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense. For example, a VDECS manufacturer could claim the credit this bill would allow and would also be allowed a deduction for business expenses attributable to the VDECS manufacturing activity. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

Conflicting tax policies result when a credit is provided for an item that is already deductible as a business expense or is depreciable (double tax benefit). On the other hand, making an adjustment to reduce basis to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

This bill would allow for an unlimited carryover period. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover period limitation because experience shows credits typically are exhausted within eight years of being earned.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO SB 462
As Introduced February 26, 2009

AMENDMENT 1

On page 1, line 4 strikeout "December" and insert:

January